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China's 5% growth target is at risk

A weaker than expected Q2 GDP print has put China's growth target of "around 5%" on a knife edge. Low expectations for the Third Plenum were largely met, with geopolitical tensions continuing to keep the authorities focused on national security and domestic resilience at the expense of more growth-friendly reforms.

Key Takeaways

- A weak Q2 GDP print, the downward revision to Q1 and a PBOC seemingly more concerned about the financial stability risks associated with low yields – rather than their root causes – has pushed our latest China forecast for 2024 down to 4.8%.
- It is possible that policies aimed at supporting the property market will put the sector on a firmer foundation in time, but June's data largely confirmed the ongoing malaise. New starts now appear to be trending down, while house prices continue to fall at a fast pace.
- Deposit and borrowing data are consistent with private sector risk aversion that is unlikely to self-correct. Corporate deposits are now shrinking, while household borrowing has fallen close to zero.
- Weak demand for funds, high savings and a tepid nominal environment (the Q2 GDP deflator remains in negative territory at -0.7% year over year) have combined to push long-dated yields down by around 50bps since November.
- But rather than address the macro backdrop, the PBOC has intervened to stem the bond market rally. If yields are forced higher – rather than stabilised – this could tighten financial conditions going forward.
- The Third Plenum seems to suggest little change in the authorities' priorities. Expanding migrants' access to social services is welcome, while fiscal reforms could reduce risks. But security remains the 'foundation' for China's technology-focused modernisation, both of which will continue to amplify tensions with the West.

GDP data fell short of market expectations

Q2 year-over-year growth printed at 4.7%, which was 0.4ppts below consensus expectations.

We were more cautious than consensus as we judged that Q1's unusual strength was already in the process of unwinding. We estimated that retail sales and fixed asset investment (FAI) expanded around 2.5% in Q1, but by May three-month growth rates had already fallen close to 0%, suggesting that a large 'payback' for Q2 was in train.

Our best guess was that Q2's sequential expansion would come in at 0.8% quarter over quarter, below the consensus of 1%. But it came in even lower, at 0.7% quarter over quarter, despite Q1 growth being revised down by 0.1ppt.

Absent revisions to the 2023 GDP profile – which boosted H1 and lowered H2 growth, thereby improving the 'statistical carry' into 2024 – we would have marked down our 2024 growth forecast by more.

Our updated forecast is now 4.8% (-0.1ppt), which leaves the authorities' growth target of "around 5%" on a knife edge. It will take only marginal downside GDP news in H2 to miss the target.

Indeed, ongoing weakness in property, a lack of consumer confidence and a weak nominal environment remain clear downside risks.

Little sign of a policy driven turnaround in property

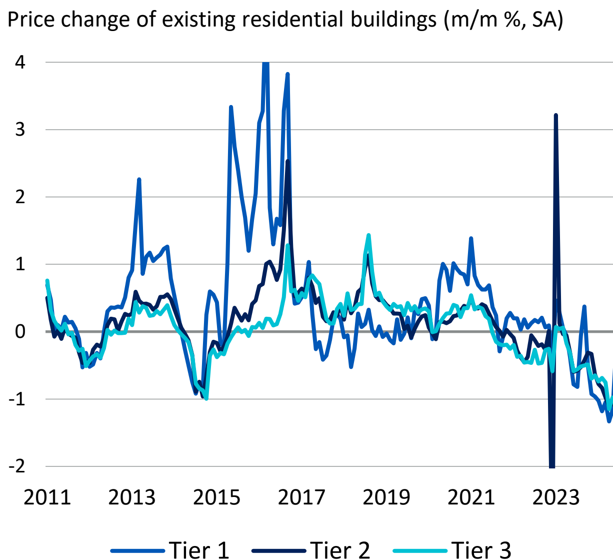
In mid-May the People's Bank of China (PBOC) announced that minimum downpayments for house purchases would be lowered by 5ppts. And it was also reported that local governments were being directed to acquire empty properties for affordable housing.

This could be a forceful step to reduce the supply-demand imbalance and turn around the fortunes of the sector, and the economy at large.

It is probably too soon to realistically expect these policies to put real estate on a firmer foundation. Local governments' finances remain strained as a result of zero-Covid expenditures and reduced land sales, implying that they may be constrained in their ability to scoop up developers' excess inventory, and financing from the central government may be necessary for this policy to gain real traction.

June data largely confirmed the ongoing malaise. New starts have continued to fall, as have investments in residential, commercial and office buildings. The 70-City indices show no respite in the price falls across new and existing properties overall – the only silver lining is the stabilisation of prices in Beijing and Shanghai after adjusting for seasonal norms (0% and +0.7% month over month respectively).

Figure 1: Tier 1 house prices only fell modestly in June



Source: Haver, abrdn, July 2024

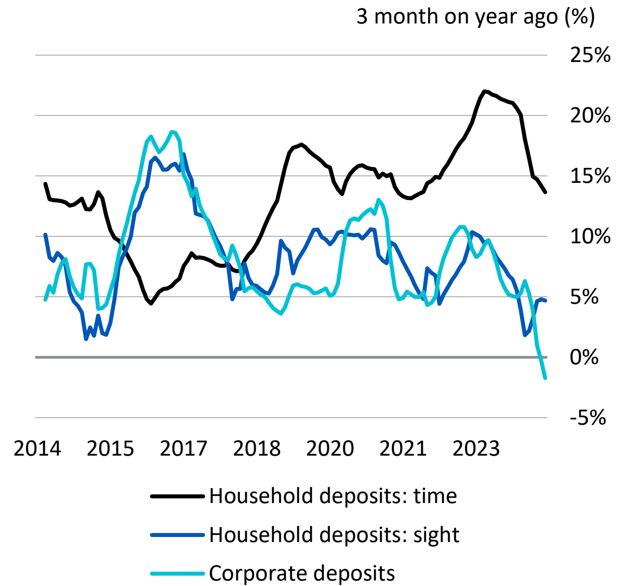
A confidence recovery remains elusive

Retail sales were well below consensus in June, at 2% year over year versus 3.4%, and we estimate that they declined around 2.8% month over month. It is likely that '618' e-commerce sales pulled some expenditure into May, thereby depressing June's retail figure, but the services production index also rose only modestly, up by 0.2% on the month, suggesting that the shifting timing of sales is not the whole story.

Quarterly national accounts data show that the saving rate remained stubbornly high in Q2, at 33.1%. The experience of zero-Covid, worsening job prospects within the service sector and the erosion of wealth from falling house prices have likely shifted the saving rate to a permanently higher equilibrium.

Indeed, household deposit growth remains skewed towards time deposits – similar to past periods of risk aversion. While the contraction of corporate deposits implies either that firms are parking money in bonds or that their revenue streams are under pressure – neither suggests the private sector is self-correcting.

Figure 2: Deposit dynamics point to risk aversion

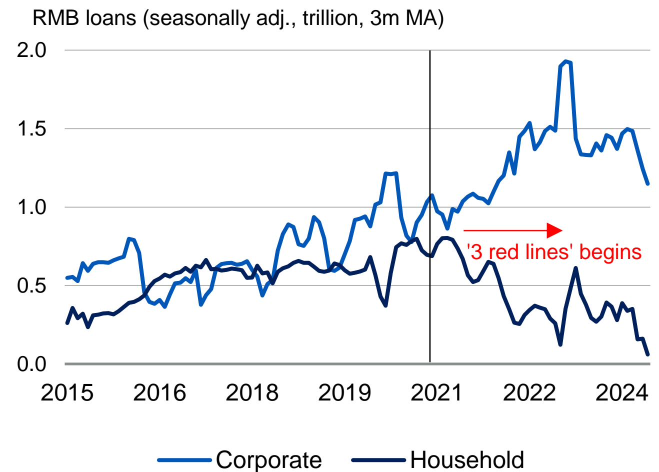


Source: Haver, abrdn, July 2024

Indeed, demand to borrow funds by the private sector – and whole economy credit growth – appears to have stepped down a gear in Q2.

Chinese credit was close to consensus in June at RMB 3.3 trillion. But after stripping out seasonal norms, June's total social financing (TSF) flow was an unremarkable RMB 2 trillion, doing little to counter the picture of soft flows across Q2 as a whole. Indeed, the average pace of credit extension in Q2 (RMB 1.8 trillion) is notably lower than the RMB 3 trillion average run rate over the prior 15 months.

Figure 3: Private sector demand for credit fell across Q2



Source: Haver, abrdn, July 2024

Faltering loan demand from corporates – which has seen the three-month average flows to June fall by RMB 0.4 trillion compared to March – adds to household borrowing, which has hit new lows. This is now close to zero (0.06 trillion), down 90% from pre-pandemic norms and consistent with little appetite to return to the housing market (see Figure 3).

The nominal environment remains weak, but policymakers are more focused on financial stability

Headline CPI inflation has now been positive for five months in a row, but it is still advancing at a tepid pace (0.2% year over year in June).

The GDP deflator remaining in negative territory (-0.7% year over year) also suggests that the authorities should do more to guard against the risk that deflation (or even 'lowflation') becomes embedded, which would push up on ex-ante rates and add another policy headache by worsening debt sustainability dynamics.

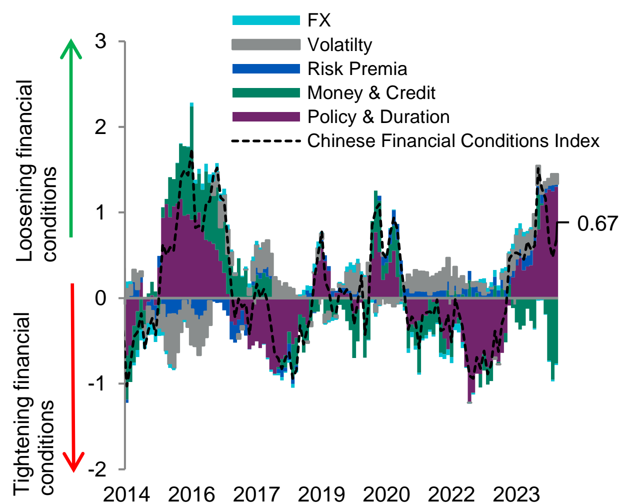
Weak demand for funds, high savings and a tepid nominal environment have combined to push long-dated yields down by around 50bps since November. But rather than address the root cause, policymakers have grown concerned about the financial sector's exposure to interest rate risk.

PBOC Governor Pan Gongsheng flagged the example of Silicon Valley Bank to illustrate why the bond rally should be stemmed: a sudden rise in yields could expose institutions to losses should they be forced to mark to market.

Financial conditions ease, but QT is a risk

The bond yield rally through to June continues to provide a boost to our China Financial Conditions Index (CFCI) via the Policy & Duration sub-component (see Figure 4). Additional support also came from a smaller drag from money supply. As such, on the month, the CFCI rose 0.19 points to 0.67.

Figure 4: Financial conditions eased in June



Source: Bloomberg, Haver, abrdn, July 2024

It is unclear whether the CFCI will remain in its current position of modest accommodation, given the PBOC's displeasure about yields.

Since early July the PBOC has been borrowing long-dated China government bonds (CGBs) from primary dealers and short-selling them try to stem the rally. This has worked to stabilise long-dated bond yields thus far, but it could potentially push them higher. As such, we see a risk that Policy & Duration factors prove less supportive to financial conditions in July.

Separately, as part of its efforts to improve control over short-term rates, the PBOC also announced a new interest rate corridor: -20bps to +50bps around the 7-day OMO rate (1.8%) operating via overnight repos and reverse repos respectively. This should reduce some volatility in short-term money market rates, but this is ultimately a technical change that should have a negligible effect on the overall policy stance.

All eyes on the Third Plenum

Announcements following China's Third Plenum largely reinforced prior low expectations, suggesting little change in the authorities' priorities.

'High quality' development and the unleashing of 'new productive forces' remain as overarching aims, with technology playing a key role in the CCP's plans for China's modernisation.

Rebalancing towards consumption has stalled since the pandemic struck, but policies could be turning more supportive. The communique flagged the need to raise living standards via improved employment prospects, social security and the health system, while the press conference unveiled plans to ease access to social services for the roughly 250 million migrant workers without Hukou residency permits.

That said, the supply-side bias to policy appears firmly entrenched.

Security remains the 'foundation' for China's modernisation drive, which requires boosting the resilience of industry and supply chains in a 'severe and complex' global backdrop.

Attempts to reassure foreign firms that China remains open for business may not be enough for foreign investors, given the looming Trump presidency.

Of course, geopolitical tensions have not stopped reforms being pushed through under Xi's watch – the increased focus on green investment and the environment has proved more ambitious than it initially appeared – but any reforms also need to be set in the context of the overarching trends since 2013, which have been the: greater role of the state, centralisation of political power and the de-risking agenda.

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